



Multistate Tax Commission Memorandum

States Working Together Since 1967 . . . To Preserve Federalism and Tax Fairness

To: Joan Wagnon, Chair
Members of the Commission

From: Shirley Sicilian, General Counsel

Date: August 3, 2006

Subject: Proposed Model Add-back Statute: Executive Committee Action, Bylaw 7 Survey Results and Possible Amendment

Attachment: Proposed Model Statute Showing Possible Amendments

I. Executive Committee Action

On April 28, 2005, the Multistate Tax Commission Executive Committee approved a Proposed Model Statute Requiring the Add-back of Certain Intangible and Interest Expenses for public hearing. Hearings were held in Washington, DC on July 18, 2005. A Hearing Officer's Report was filed with the Executive Committee on October 10, 2005, and pursuant to the Hearing Officer's recommendation, the proposal was referred back to the Uniformity Committee for additional work. An additional Hearing Officer memorandum was submitted to the Executive Committee for consideration at its May 12, 2006 meeting. At its May meeting, the Executive Committee voted to refer the Proposed Model Add-Back Statute to the Full Commission, with amendments as recommended by the Hearing Officer.

II. Bylaw 7 Survey

On June 15, 2006, a Bylaw 7 Survey regarding the proposed model add-back statute was sent to the Compact Member States. A majority of the affected Compact member states have responded affirmatively to the survey, indicating that they would consider adoption of the draft proposal. Thus, the matter may be referred to the full Commission for a vote and possible adoption as a uniformity recommendation.

III. Possible Amendment

Also at its May, 2006 meeting, the Executive Committee directed staff to convene a teleconference with interested parties to discuss a possible amendment to add a safe harbor provision whereby a taxpayer could avoid expense add-back and credit subtraction altogether, and to report back to the Full Commission so that it might consider making such an amendment prior to voting on the Proposal.

A. Background

The Proposal now before the Full Commission would require an add-back of certain royalty and interest expenses incidental to the licensing by a related intangible holding company of the unitary business's trademarks and trade names. No add-back is required if 1) the

transaction giving rise to the expense was undertaken for a valid business purpose, and 2) a) in the case of an interest expense, the expense reflects an arm's length relationship, or b) in the case of an intangible expense, the related member in turn paid the amount to a person that is not a related member.

As it was originally passed by the Uniformity Committee, the Proposal also provided an exemption from the add-back requirement where the related member to whom the expense was paid was subject to tax on the net income related to that expense at an effective rate that was the same or substantially similar to the rate that would have applied in the taxpayer's jurisdiction. The criteria for meeting the exemption differed depending on whether the affiliate was subject to tax in one of the 50 states or in a foreign jurisdiction. A foreign affiliate could qualify for the exemption only if its taxing jurisdiction had entered into a tax treaty with the United States and the rate was equal to or greater than the state's rate (as opposed to being within a certain percentage).

At public hearing, commenters suggested that limiting the foreign affiliate exemption in this manner could run afoul of the commerce clause. To address these concerns, the hearing officer recommended eliminating the exemption approach and substituting a credit approach. Under the credit approach, a taxpayer that has been required to add-back an expense is entitled to a credit against tax due equal to tax paid by the related member on its income that results from the intangible expense paid by the taxpayer.

As noted above, the Executive Committee approved the Hearing Officer's recommended proposal with the credit approach, and this is the proposal currently before the Full Commission. However, the Executive Committee suggested the Full Commission may wish to consider amendments to restore the exemption approach, in addition to the credit approach. The restoration of the exemption approach would act as a "safe harbor" whereby a taxpayer could avoid expense add-back and credit subtraction altogether in cases where the related member to whom the expense was paid was subject to tax on the income related to that expense at an effective rate that is the same or substantially similar to the rate that would have applied in the taxpayer's jurisdiction.

The Executive Committee asked staff to convene a meeting of interested parties to comment on the addition of this safe-harbor. Staff consulted with the original drafting group¹; drafted possible amendments by restoring the previously deleted exemption language; and convened a teleconference, held July 26, 2006, to discuss the possible amendments.

B. Discussion

No participants spoke against the amendment in concept. Two state participants spoke in favor of the amendment, explaining that although it adds another layer of complexity, it may be worth the extra calculation in terms of administering the add-back fairly and the Proposal's overall acceptance by the taxpayer community.

¹ These members included Michael Fatale, MA; Frank O'Connell, GA; Joe Garrett, AL; and Wood Miller, MO.

It was noted that restoration of the exemption language restores the commerce clause issue. Because domestic related entities are subject to a less stringent safe harbor test than foreign related entities, it is possible that a domestic affiliate may fall within the safe harbor provision while an identically situated foreign affiliate may not. If the exemption is discriminatory between domestic related entities and foreign related entities, the existence of the credit provision does not cure the situation. This is because the credit will only partially offset the add-back for expenses paid to a foreign affiliate; while expenses paid to the domestic affiliate will not be subject to add back at all.

However, it was also pointed out that although the criteria are different as between foreign and domestic affiliates, the difference is not necessarily discriminatory. Discrimination requires differential treatment of two otherwise comparable groups. The rate applicable to foreign affiliates is a national rate, more comparable to the federal rate in the United States than to the sub-national, state rates. Arguably, the two provisions are addressing two different, incomparable situations.

Attached to this Memorandum is the Proposed Model Statute, as approved by Executive Committee and submitted to the Bylaw 7 survey, showing the possible safe harbor amendments in “track change.”

(Attachment)

**Proposed Model Statute Requiring the Add-back of
Certain Intangible and Interest Expenses**

As Approved by Executive Committee
for Submission to a By-Law 7 Survey on May 11, 2006,
Showing Possible Amendments for Consideration by the Full Commission

Section 1.

(a) As used in this section, the following words shall, unless the context requires otherwise, have the following meanings:

(i) "Aggregate effective rate of tax" means the sum of the effective rates of tax imposed by a state or U.S. possession or any combination thereof on a related member.

(ii) "Code" means the federal Internal Revenue Code as amended and in effect for the taxable year.

(iii) "Effective rate of tax" means, as to any state or U.S. possession, the maximum statutory rate of tax imposed by the state or possession on a related member's net income multiplied by the apportionment percentage, if any, applicable to the related member under the laws of said jurisdiction. For purposes of this definition, the effective rate of tax as to any state or U.S. possession is zero where the related member's net income tax liability in said jurisdiction is reported on a combined or consolidated return including both the taxpayer and the related member where the reported transactions between the taxpayer and the related member are eliminated or offset. Also, for purposes of this definition, when computing the effective rate of tax for a jurisdiction in which a related member's net income is eliminated or offset by a credit or similar adjustment that is dependent upon the related member either maintaining or managing intangible property or collecting interest income in that jurisdiction, the maximum statutory rate of tax imposed by said jurisdiction shall be decreased to reflect the statutory rate of tax that applies to the related member as effectively reduced by such credit or similar adjustment.

(~~iii~~iv) "Intangible expense" includes (1) expenses, losses and costs for, related to, or in connection directly or indirectly with the direct or indirect acquisition, use, maintenance or management, ownership, sale, exchange, or any other disposition of intangible property to the extent such amounts are allowed as deductions or costs in determining taxable income before operating loss deductions and special deductions for the taxable year under the Code; (2) amounts directly or indirectly allowed as deductions under section 163 of the Code for purposes of determining taxable income under the Code to the extent such expenses and costs are directly or indirectly for, related to, or in connection with the expenses, losses and costs referenced in (1); (3) losses related to, or incurred in connection directly or indirectly with, factoring transactions or discounting transactions; (4) royalty, patent, technical and copyright fees; (5) licensing fees; and (6) other similar expenses and costs.

(~~iv~~v) "Intangible property" includes patents, patent applications, trade names, trademarks, service marks, copyrights, mask works, trade secrets and similar types of intangible assets.

(~~iv~~vi) "Related entity" means (1) a stockholder who is an individual, or a member of the stockholder's family set forth in section 318 of the Code if the stockholder and the members of the stockholder's family own, directly, indirectly, beneficially or constructively, in the aggregate, at least 50 per cent of the value of the taxpayer's outstanding stock; (2) a stockholder, or a stockholder's partnership, limited liability company, estate, trust or corporation, if the stockholder and the stockholder's partnerships, limited liability companies, estates, trusts and corporations own directly, indirectly, beneficially or constructively, in the aggregate, at least 50 per cent of the value of the taxpayer's outstanding stock; or (3) a corporation, or a party related to the corporation in a manner that would require an attribution of stock from the corporation to the party or from the party to the corporation under the attribution rules of the Code if the taxpayer owns, directly, indirectly, beneficially or constructively, at least 50 per cent of the value of the corporation's outstanding stock. The attribution rules of the Code shall apply for purposes of determining whether the ownership requirements of this definition have been met.

(vii) "Related member" means a person that, with respect to the taxpayer during all or any portion of the taxable year, is: (1) a related entity, (2) a component member as defined in subsection (b) of section 1563 of the Code; (3) a person to or from whom there is attribution of stock ownership in accordance with subsection (e) of section 1563 of the Code; or (4) a person that, notwithstanding its form of organization, bears the same relationship to the taxpayer as a person described in (1) to (3), inclusive.

(viii) "Valid business purpose" means one or more business purposes, other than the avoidance or reduction of taxation, which alone or in combination constitute the primary motivation for a business activity or transaction, which activity or transaction changes in a meaningful way, apart from tax effects, the economic position of the taxpayer. The economic position of the taxpayer includes an increase in the market share of the taxpayer or the entry by the taxpayer into new business markets.

(b) For purposes of computing its net income under this chapter, a taxpayer shall add back otherwise deductible intangible expense directly or indirectly paid, accrued or incurred in connection with one or more direct or indirect transactions with one or more related members.

(c) ~~+~~ If the related member was subject to tax in this state or another state or possession of the United States or a foreign nation or some combination thereof on a tax base that included the intangible expense paid, accrued or incurred by the taxpayer, the taxpayer shall receive a credit against tax due in this state in an amount equal to the higher of the tax paid by the related member with respect to the portion of its income representing the intangible expense paid, accrued or incurred by the taxpayer, or the tax that would have been paid by the related member with respect to that portion of its income if (1) that portion of its income had not been offset by expenses or losses or (2) the tax liability had not been offset by a credit or credits. The credit so determined shall be multiplied by the apportionment factor of the taxpayer in this state. However, in no case shall the credit exceed the taxpayer's liability in this state attributable to the net income taxed as a result of the adjustment required by subsection (b).

(d) ~~(ii)~~(i) The adjustment required in subsection (b) and the credit allowed in subsection (c) shall not apply to the portion of the intangible expense that the taxpayer establishes by clear and convincing evidence meets both of the following requirements: (A) the related member during the same taxable year directly or indirectly paid, accrued or incurred such portion to a person that is not a related member, and (B) the transaction giving rise to the intangible expense between the taxpayer and the related member was undertaken for a valid business purpose.

(ii) The adjustment required in subsection (b) and the credit allowed in subsection (c) shall not apply if the taxpayer establishes by clear and convincing evidence of the type and in the form specified by the commissioner that (A) the related member was subject to tax on its net income in this state or another state or possession of the United States or some combination thereof; (B) the tax base for said tax included the intangible expense paid, accrued or incurred by the taxpayer; and (C) the aggregate effective rate of tax applied to the related member is no less than [X%] [the statutory rate of tax applied to the taxpayer under this chapter minus Y percentage points].

(iii) The adjustment required in subsection (b) and the credit allowed in subsection (c) shall not apply if the taxpayer establishes by clear and convincing evidence of the type and in the form specified by the commissioner that (A) the intangible expense was paid, accrued or incurred to a related member organized under the laws of a country other than the United States; (B) the related member's income from the transaction was subject to a comprehensive income tax treaty between such country and the United States, (C) the related member's income from the transaction was taxed in such country at a tax rate at least equal to that imposed by this state; and (D) the intangible expense was paid, accrued or incurred pursuant to a transaction that was undertaken for a valid business purpose and using terms that reflect an arm's length relationship.

~~(iiiiv)~~ The adjustment required in subsection (b) and the credit allowed in subsection (c) shall not apply if the corporation and the commissioner agree in writing to the application or use of alternative adjustments or computations. The commissioner may, in his/her discretion, agree to the application or use of alternative adjustments or computations when he/she concludes that in the absence of such agreement the income of the taxpayer would not be properly reflected.

~~(de)~~ Nothing in this subsection shall be construed to limit or negate the commissioner's authority to otherwise enter into agreements and compromises otherwise allowed by law.

~~(ef)~~ Nothing in this section shall be construed to limit or negate the commissioner's authority to make adjustments under section ___ [i.e., the state's transfer pricing authority, if any].

Section 2.

(a) As used in this section, the following words shall, unless the context requires otherwise, have the following meanings:-

(i) "Aggregate effective rate of tax" means the sum of the effective rates of tax imposed by a state or U.S. possession or any combination thereof on a related member.

(ii) "Code" means the federal Internal Revenue Code as amended and in effect for the taxable year.

(iii) "Effective rate of tax" means, as to any state or U.S. possession, the maximum statutory rate of tax imposed by the state or possession on a related member's net income multiplied by the apportionment percentage, if any, applicable to the related member under the laws of said jurisdiction. For purposes of this definition, the effective rate of tax as to any state or U.S. possession is zero where the related member's net income tax liability in said jurisdiction is reported on a combined or consolidated return including both the taxpayer and the related member where the reported transactions between the taxpayer and the related member are eliminated or offset. Also, for purposes of this definition, when computing the effective rate of tax for a jurisdiction in which a related member's net income is eliminated or offset by a credit or similar adjustment that is dependent upon the related member either maintaining or managing intangible property or collecting interest income in that jurisdiction, the maximum statutory rate of tax imposed by said jurisdiction shall be decreased to reflect the statutory rate of tax that applies to the related member as effectively reduced by such credit or similar adjustment.

(~~iii~~iv) "Interest expense" means amounts directly or indirectly allowed as deductions under section 163 of the Code for purposes of determining taxable income under the Code.

(~~iii~~iv) "Related entity" means (1) a stockholder who is an individual, or a member of the stockholder's family set forth in section 318 of the Code if the stockholder and the members of the stockholder's family own, directly, indirectly, beneficially or constructively, in the aggregate, at least 50 per cent of the value of the taxpayer's outstanding stock; (2) a stockholder, or a stockholder's partnership, limited liability company, estate, trust or corporation, if the stockholder and the stockholder's partnerships, limited liability companies, estates, trusts and corporations own directly, indirectly, beneficially or constructively, in the aggregate, at least 50 per cent of the value of the taxpayer's outstanding stock; or (3) a corporation, or a party related to the corporation in a manner that would require an attribution of stock from the corporation to the party or from the party to the corporation under the attribution rules of the Code if the taxpayer owns, directly, indirectly, beneficially or constructively, at least 50 per cent of the value of the corporation's outstanding stock. The attribution rules of the Code shall apply for purposes of determining whether the ownership requirements of this definition have been met.

(~~iv~~vi) "Related member" means a person that, with respect to the taxpayer during all or any portion of the taxable year, is: (1) a related entity, (2) a component member as defined in subsection (b) of section 1563 of the Code; (3) a person to or from whom there is attribution of stock ownership in accordance with subsection (e) of section 1563 of the Code; or (4) a person that, notwithstanding its form of organization, bears the same relationship to the taxpayer as a person described in (1) to (3), inclusive.

(vii) "Valid business purpose" means one or more business purposes, other than the avoidance or reduction of taxation, which alone or in combination constitute the primary motivation for a business activity or transaction, which activity or transaction changes in a meaningful way, apart from tax effects, the economic position of the taxpayer. The economic position of the taxpayer includes an increase in the market share of the taxpayer or the entry by the taxpayer into new business markets.

(b) For purposes of computing its net income under this chapter, a taxpayer shall add back otherwise deductible interest paid, accrued or incurred to a related member during the taxable year.

(c) ~~(i)~~ If the related member was subject to tax in this state or another state or possession of the United States or a foreign nation or some combination thereof on a tax base that included the interest expense paid, accrued or incurred by the taxpayer, the taxpayer shall receive a credit against tax due in this state equal to the higher of the tax paid by the related member with respect to the portion of its income representing the interest expense paid, accrued or incurred by the taxpayer, or the tax that would have been paid by the related member with respect to that portion of its income if (1) that portion of its income had not been offset by expenses or losses or (2) the tax liability had not been offset by a credit or credits. The credit so determined shall be multiplied by the apportionment factor of the taxpayer in this state. However, in no case shall the credit exceed the taxpayer's liability in this state attributable to the net income taxed as a result of the adjustment required by subsection (b)

(d) ~~(ii)~~ The adjustment required in subsection (b) and the credit allowed in subsection (c) shall not apply if the taxpayer establishes by clear and convincing evidence, of the type and in the form determined by the commissioner, that (A) the transaction giving rise to interest expense between the taxpayer and the related member was undertaken for a valid business purpose, and (B) the interest expense was paid, accrued or incurred using terms that reflect an arm's length relationship.

(ii) The adjustment required in subsection (b) and the credit allowed in subsection (c) shall not apply if taxpayer establishes by clear and convincing evidence of the type and in the form specified by the commissioner that (A) the related member was subject to tax on its net income in this state or another state or possession of the United States or some combination thereof; (B) the tax base for said tax included the interest expense paid, accrued or incurred by the taxpayer; and (C) the aggregate effective rate of tax applied to the related member is no less than [X %] [the statutory rate of tax applied to the taxpayer under this chapter minus Y percentage points].

(iii) The adjustment required in subsection (b) and the credit allowed in subsection (c) shall not apply if the taxpayer establishes by clear and convincing evidence of the type and in the form specified by the commissioner that (A) the interest expense is paid, accrued or incurred to a related member organized under the laws of a country other than the United States; (B) the related member's income from the transaction is subject to a comprehensive income tax treaty between such country and the United States; (C) the related member's income from the transaction is taxed in such country at a tax rate at least equal to that imposed by this state; and (D) the interest expense was paid, accrued or incurred pursuant to a transaction that was undertaken for a valid business purpose and using terms that reflect an arm's length relationship.

(iv) The adjustment required in subsection (b) and the credit allowed in subsection (c) shall not apply if the corporation and the commissioner agree in writing to the application or use of alternative adjustments or computations. The commissioner may, in his/her discretion, agree to the application or use of alternative adjustments or computations when he/she concludes that in the absence of such agreement the income of the taxpayer would not be properly reflected.

(~~d~~e) Nothing in this subsection shall be construed to limit or negate the commissioner's authority to otherwise enter into agreements and compromises otherwise allowed by law.

(~~e~~f) Nothing in this section shall be construed to limit or negate the commissioner's authority to make adjustments under section ____ [i.e., the state's transfer pricing authority, if any].